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FILED
DEC

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1961

NO. 602

CHRIS J. SHERLOCK and LENORA SHERLOCK (Lenora Chapman Sherlock, Executrix under the Last Will and Testament of Chris J. Sherlock, substituted as party petitioner in the place and stead of Chris J. Sherlock, deceased).

Petitioner

vs.

COMMISSIONER OF INTERNAL REVENUE

Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

WILLIAM S. PRITCHARD,
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PRITCHARD, McCALL & JONES,
Of Counsel.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1961

NO.

CHRIS J. SHERLOCK and LENORA SHERLOCK
(Lenora Chapman Sherlock, Executrix under the Last Will and Testament of Chris J. Sherlock, substituted as party petitioner in the place and stead of Chris J. Sherlock, deceased),

Petitioner

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

TO THE HONORABLE CHIEF JUSTICE AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Your Petitioner, Lenora Chapman Sherlock, Executrix under the Last Will and Testament of Chris J. Sherlock, deceased, and Lenora Sherlock, respectfully prays for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit to review a decision entered September 27, 1961, affirming a decision of the Tax Court of the United States.

a. Opinions of Courts Below

The opinion of the United States Circuit Court of Appeals for the Fifth Circuit is reported in 294 F. 2d 863 and is appended hereto as Exhibit A. The opinion of the Tax

Court of the United States is reported in 34 T.C. 522. These opinions appear at pages 21-32 and pages 88-98 of the record.

b. Jurisdiction

Jurisdiction of this Court to review the judgment in question by Writ of Certiorari is conferred by the United States Code 1952 ed., Title 28, Section 1254. The date of the judgment sought to be reviewed is September 27, 1961. The date of the order denying petition for rehearing, appended as Exhibit B, is October 30, 1961.

c. Question Presented

The question presented by this petition is whether under the Internal Revenue Code of 1939, gain from a sale for a lump sum of a partner's one-third interest in a partnership to his partners prior to the end of the partnership's fiscal year was taxable as a capital asset, even though some uncollected receivables were included in the interest sold.

d. Statutes

"CAPITAL GAINS AND LOSSES—(a) DEFINITIONS. As used in this chapter—

(1) CAPITAL ASSETS. The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) Property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l), or real property used in his trade or business;

(C) A copyright; a literary, musical, or artistic composition; or similar property; held by—

(i) A taxpayer whose personal efforts created such property, or

(ii) A taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property; or

(D) An obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue."

Sec. 117 Internal Revenue Code of 1939
Title 26 U. S. Code, 1952 ed., Sec. 117 (a)

e. Statement of the Case

The taxpayer, Chris J. Sherlock, now deceased on February 26, 1954, received $70,000.00 as the sales price of his entire one-third interest in the partnership Sherlock, Smith and Adams, Montgomery, Alabama, organized on June 1, 1951. Taxpayer reported his gain therefrom as long term capital gain. Among the assets included in the partnership interest sold were receivables entered on the partnership books two days after the sale, in which taxpayer's share would have amounted to $49,827.38. The partnership was on a fiscal year basis ending April 30th of each year in reporting its taxable income. Until the end of each partnership fiscal year the partners were not entitled to receive any partnership profits.

Although the interest sold was taxpayer's entire interest in the partnership entity without a break-down as to individual items included therein, the Commissioner of Internal Revenue determined the amount of $ 49,827.38 to be ordi-

nary income. The Commissioner's determination was sustained by the Tax Court of the United States and by the United States Court of Appeals for the Fifth Circuit, with Circuit Judge John R. Brown dissenting.

f. Reasons Relied on for Allowance of Writ

The decision below is in conflict with the following decisions of the Sixth, Seventh and Eighth Circuits:

Berry v. United States,
6th Cir. 1959, 267 F. 2d 298

Meyer v. Commissioner,
7th Cir. 1954, 213 F. 2d 278

Swiren v. Commissioner,
7th Cir. 1950, 183 F. 2d 656, cert. den. 340 U. S. 912, 71 S. Ct. 293, 95 L. Ed. 659.

United States v. Donoho,
8th Cir. 1960, 275 F. 2d 489

United States v. Shapiro,
8th Cir. 1949, 178 F. 2d 459.

These cases hold that the sale of a partnership interest in a going concern is not the sale of the individual assets of the partnership, but is rather the sale of an indivisible part of a whole partnership entity. As such the entire sales price is to be attributed to a sale of a capital asset. As stated in the language of Judge Brown's opinion below, (R98)

> "The transaction is a sale of an entire interest. It is the sale which is the decisive factor. What is sold is not merely the right to receive income theretofore earned and thereafter to be realized from past operations. It comprehends everything. The everything happens to include as an indivisible part what has been, or will shortly be, earned from prior operations. The sale of all is the thing."

Congress has recognized the conflict in the proper determination of the issue here. The Committee on Ways and Means of the House of Representatives in its report accompanying H. R. 8300, which subsequently became the Internal Revenue Code of 1954, reads as follows:

> "Under present decisions the sale of a partnership interest is generally considered to be a sale of a capital asset, and any gain or loss realized is treated as capital gain or loss. It is not clear whether the sale of an interest whose value is attributable to uncollected rights to income gives rise to capital gain or ordinary income."
>
> *House Report No. 1337, 83rd Congress, Second Sess., March 9, 1954, page 70.*

This recognized conflict in the Circuits should be resolved by a decision in this case by this Honorable Court.

WHEREFORE, your Petitioner respectfully prays that a Writ of Certiorari be issued under the seal of this Court directed to the United States Court of Appeals for the Fifth Circuit, to the end that this case may be reviewed and determined by this Court and that the judgment of the United States Court of Appeals for the Fifth Circuit entered in the case below be reversed and a judgment be rendered for Petitioner.

WILLIAM S. PRITCHARD,

WINSTON B. McCALL,
831 Frank Nelson Building
Birmingham, Alabama
Counsel for Petitioner.

PRITCHARD, McCALL & JONES,
Of Counsel.

CERTIFICATE OF SERVICE

The undersigned, counsel of record for Petitioner, does hereby certify that a copy of the foregoing Petition for Writ of Certiorari has been served upon Respondent by mailing a copy thereof air mail, postage prepaid, to the Solicitor General, Department of Justice, Washington 25, D. C., on this the 8th day of December, 1961.

WINSTON B. McCALL
Of Counsel for Petitioner

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 18680

CHRIS J. SHERLOCK and LENORA SHERLOCK (Lenora Chapman Sherlock, Executrix under the Last Will and Testament of Chris J. Sherlock, substituted as party petitioner in the place and stead of Chris J. Sherlock, deceased),

Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Review of Decision of the Tax Court of the United States (District of Alabama).

(September 27, 1961)

Before RIVES, JONES and BROWN, Circuit Judges.

JONES, Circuit Judge: The Commissioner of Internal Revenue determined a deficiency in the income tax payable for the year 1954 by Chris J. Sherlock and Lenora Sherlock, his wife. The taxpayers contested the Commissioner's determination and the Tax Court resolved the issues against them. Sherlock v. Commissioner, 34 T. C. 522.

EXHIBIT "A"

The taxpayers petitioned this Court to review the Tax Court's decision. While the proceeding was pending before this Court, Chris J. Sherlock died and his wife, as his Executrix, was substituted for him as a Petitioner. Since only the income of Chris J. Sherlock is involved in the computation of the tax deficiency, he will be generally referred to as the taxpayer.

On June 1, 1951, the taxpayer entered into a partnership agreement with Moreland Griffith Smith and Richard J. Adams under the name of Sherlock, Smith and Adams. The firm rendered engineering and architectural services. The taxpayer was the engineer. Smith and Adams were architects. The partnership agreement provided, among other things, that profits and losses should be borne equally by the partners, that any partner might withdraw upon giving notice and in such event the other partners could either discontinue the partnership business or buy the interest of the withdrawing partner. The partnership kept books on the basis of fiscal years ending April 30, and used the accrual method of accounting. On February 26, 1954, the taxpayer made a sale of his interest in the partnership to his partners, Smith and Adams, and on that day the parties entered into an agreement intended to express the terms of the sale. It fixed a price of $70,000 to be paid to the taxpayer for his interest of which $20,000 was payable in cash, and the balance was to be paid at the rate of $1,666.66 per month out of partnership earnings and assets. The agreement provided that:

> "The books of the firm will be closed as of February 28, 1954, and seller withdraws as member of the firm and buyers will prepare, as soon as

possible thereafter, returns of the income reflecting the profit and loss of the partnership for the period beginning June 1, 1953, and ending February 28, 1954. The profit between Chris J. Sherlock, Moreland Smith and Richard Adams; said returns shall be filed with the respective Governments and each of the parties will report their respective income from the partnership as shown by such returns. It is agreed that the profit and loss shown by such partnership to be the profit and loss of Sherlock has been received by him either through previous withdrawals or in the purchase price paid or to be paid by buyers."

The partnership filed an income tax return for the period commencing May 1, 1953, and ending February 28, 1954, reporting ordinary net income of the partnership in the amount of $249,827.38, with $83,275.79 distributable to the taxpayer. The taxpayer, in the joint return of his wife and himself reported the $70,000 as long-term capital gain with a zero basis. None of his share of the partnership earnings for the May 1, 1953, to February 24, 1954, partnership period was returned by the taxpayer as ordinary income. The Commissioner determined that the distributive share of partnership earnings as reported in the partnership return in the amount of $83,275.79 was ordinary income of the taxpayer and computed a deficiency by including that amount as taxable ordinary income and reducing the amount of the capital gain. At the trial before the Tax Court it was stipulated that the ordinary income of the partnership for the May 1, 1953, to February 28, 1954, fiscal year was $147,827.38, of which the taxpayer's share was $49,827.38, that at the time the taxpayer sold his partner-

ship interest he was overdrawn resulting in capital deficit of $9,641.59, and that his withdrawals during the year amounted to $14,233.97. The Tax Court made a re-determination of the tax using the amount of $49,827.38 as the taxpayer's share of partnership earnings instead of the figure of $83,275.79 used by the Commissioner, with such adjustments in the computations as that change made necessary. The Tax Court sustained the Commissioner's additions to the tax, with appropriate adjustments, under Sections 294 (d) (1) (B) and 294 (d) (2) of the Internal Revenue Code of 1939, for failure to make timely payments of installments of estimated tax and for substantial underestimate of estimated tax.

It is contended on behalf of the taxpayer that subsequent to the sale of his interest on February 26, 1954, but on or as of February 28, 1954, or prior thereto, accounts receivable were accrued on the partnership books in the amount of $194,904.04 without the knowledge of the taxpayer, and had he known there were accruals of that amount he would have bought instead of selling. It is here urged that these uncollected accruals should not be included in the partnership earnings and hence should not be reckoned, to any extent, in the determination of the income tax of Sherlock. Since the amount of the ordinary income of the partnership has been stipulated this contention need not be considered so far as the partnership is concerned. Whether it should be used in determining the taxable income of the taxpayer, and if so, how it should be used are the questions before us.

The primary question for our decision is whether, upon the sale for a lump sum by the taxpayer of his partner-

ship interest to his former partners prior to the end of the partnership's fiscal year, the amount of the taxpayer's share of undistributed earnings which accrued during the period are taxable to him as ordinary income. The Tax Court determined that his ratable share of such accruals were taxable to him as ordinary income.

The Internal Revenue Service followed the practice, prior to 1950, of treating the sale of a partnership interest as a sale of the selling partner's undivided interest in each specific partnership asset. Whether gains or losses were treated as ordinary income or as capital gains depended, under this theory, sometimes referred to as the aggregate concept, upon the character of each specific item of the partnership's property at the time of the sale. A majority of the court, including this Court[1] adopted the so-called entity concept[2] under which the interest of a partner was regarded as an interest held in common with his co-partners in the whole of the partnership assets without any separate rights in the specific items of which the whole is composed. *Commissioner v Smith, supra.* The Internal Revenue Service reconciled itself to the entity theory and changed to the view that the sale of the partnership interest should be treated as a sale of a capital asset, except that payments of a distributive share of earnings for past services should be treated as ordinary income. G. C. M. 26379, C. B. 1950-1 p. 58.

[1]Commissioner v. Smith, 5th Cir. 1949, 173 F. 2d 470, cert. den. 338 U. S. 818, 70 S. Ct. 61, 99 L. Ed. 496; Long v. Commissioner, 5th Cir. 1949, 173 F. 2d 471, cert. den. 338 U. S. 819, 70 S. Ct. 61, 94 L. Ed. 496.

[2]For discussions of the aggregate and entity concepts, so called, see Surrey and Warren, The Income Tax Project of the American Law Institute, 66 Harv. L. Rev. 1161, 1171; Anderson and Coffee, Proposed Revision of Partner and Partnership Taxation, 15 Tax L. Rev. 497.

The position of the Internal Revenue Service has been sustained by the Second,[3] Third,[4] Fourth[5] and Ninth[6] Circuits, as well as by the Tax Court.[7] Three Circuits, the Sixth,[8] Seventh[9] and Eighth[10] have adopted a contrary view. It has been suggested, however, that in its latest decision[11] the Seventh Circuit has departed from its holdings in the Meyer and Swiren cases and aligned itself with the majority. 6 Mertens, Law of Federal Income Taxation, 168, § 35.55. In the enactment of the 1954 Code it was recognized by Congress that "It is not clear whether the sale of an interest whose value is attributable to uncollected rights to income gives rise to capital gain or ordinary income" H. R. Rep. No. 1337, 3 U. S. Code Cong. and Adm. News 4096. And "Because of the confusion in this area, basic rules have been set forth in order to clarify tax treatment and at the same time to prevent the use of the sale of an interest in a partnership as a device for converting rights to income into capital gain", Id. The rule for which the Internal Revenue Service here contends was adopted in the Internal Revenue Code of 1954. 26 U. S. C. A. (IRC 1954) §§ 741, 751.

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[3]Leff v. Commissioner, 2nd Cir. 1956, 235 F. 2d 439; Helvering v. Smith, 2nd Cir. 1937, 90 F. 2d 590.

[4]Tunnell v. United States, 3rd Cir. 1958, 239 F. 2d 916.

[5]Doyle v. Commissioner, 4th Cir. 1939, 102 F. 2d 86.

[6]United States v. Snow, 9th Cir. 1955, 223 F. 2d 103, cert. den. 350 U. S. 831, 76 S. Ct. 64, 100 L. Ed. 741; Trousdale v. Commissioner, 9th Cir. 1955, 219 F. 2d 563.

[7]Estate of William Goldstein v. Commissioner, 29 T. C. 931; Specker v. Commissioner, 26 T. C. 91; Johnson v. Commissioner, 21 T. C. 733.

[8]Berry v. United States, 6th Cir. 1959, 267 F. 2d 298.

[9]Meyer v. Commissioner, 7th Cir. 1954, 213 F. 2d 278; Swiren v. Commissioner, 7th Cir. 1950, 183 F. 2d 656, cert. den. 340 U. S. 912, 71 S. Ct. 293, 95 L. Ed. 659.

[10]United States v. Donoho, 8th Cir. 1960, 275 F. 2d 489; United States v. Shapiro, 8th Cir. 1949, 178 F. 2d 459.

[11]Hulbert v. Commissioner, 7th Cir. 1955, 227 F. 2d 399.

Although the taxpayer is most vigorous in contending otherwise we think this Court has identified itself with the majority in *Le Sage v. Commissioner*, 5th Cir. 1949, 173 F. 2d 826. There it was held that the share of earnings of the selling partner between January 1, 1943, the date of the balance sheet fixing the partners' capital investments, and November 15, the date as of which the sale of the partnership interest was made, was taxable as ordinary income to the seller. In the opinion it is said:

> "The Tax Court held that a part of the difference between cost and sale price represented petitioner's distributive share of profits between January 1 and November 15, 1943, and was taxable as ordinary income, and that only the balance remaining after the income figure was deducted was capital gain. Both the evidence and the law lend support to this holding." 173 F. 2d 826, 827.

It seems likely, although it is not too clear from the opinion, that the undistributed earnings in Le Sage had been realized. This is not true with respect to the partnership of which the taxpayer, Sherlock, was a member. But the Sherlock partnership used the accrual method of accounting so the same rule would be applicable. The question is not before us as to whether the same rule would apply with respect to unrealized income of a cash basis partnership. The Le Sage case was decided in the month following the Long and Smith cases, supra. The same panel of the Court heard all three cases. In Long and Smith the entity approach is followed and the general rule adopted that the

sale of a partnership interest is the sale of a capital asset entitled to capital gains treatment in determining Federal income tax liability. Le Sage recognizes and applies the corollary rule that the seller's share of undistributed and untaxed profits are taxable to him as ordinary income.

If we were persuaded that Le Sage was not a precedent by which we are bound, and if we did not feel that we should follow those decisions of other courts which we regard as representing the weight of authority, we should nevertheless reach the conclusion that fundamental principles required the reaching of the same result as that of the Tax Court. The purpose of the capital gains provisions of the Income Tax law is to relieve a taxpayer of excessive tax burdens on gains resulting from a conversion of capital investments. *Burnet v. Harmel*, 287 U. S. 103, 53 S. Ct. 74, 77 L. Ed. 743. One who makes a present transfer of a right to receive income at a future date has realized taxable ordinary income by the transaction. *Commissioner v. P. G. Lake, Inc.*, 356 U. S. 260, 78 S. Ct. 691, 2 L. Ed. 2d 743; *Harrison v. Schaffner*, 312 U. S. 579, 61 S. Ct. 759, 85 L. Ed. 1055; *Helvering v. Horst*, 311 U. S. 112, 61 S. Ct. 144, 85 L. Ed. 75. The right to receive a share of ordinary income earned by a partnership does not become a capital asset upon its sale even though the sale is of a partnership interest. *Tunnell v. United States, supra; United States v. Snow, supra.* We are in agreement with the Tax Court in holding that the taxpayer's realization for the sale of the partnership earnings was ordinary income to him.

The contention is made that no part or share of accrued accounts which were not charged until after the making of the sale should be included in determining the taxpay-

er's income. The point is urged that under the partnership practices the accruals could not have been made on the books without his agreeing thereto and he did not agree. We again observe that the agreement for the sale of his interest contained a provision that the buyers would prepare returns of the income reflecting profit and loss up to February 28, 1954. Since it was his partners who were to make these determinations, it cannot be said that his agreement or acquiescence was required. It is said that the sale occurred on February 26, 1954, and that accruals after that date should not be used in ascertaining the taxpayer's income. The agreement provides that the income should be computed for the period ending February 28, 1954. It cannot be said that entries and computations to be "as of February 28, 1954" must have been made on or before that date. But these questions need not detain us. The parties have stipulated as to the ordinary net income of the partnership for the period ending February 28, 1954. The stipulation disposes of all questions as to the accrual of income so far as it is germane to the issues before us.

Since the questions of tax liability are resolved against the taxpayer, it follows that the additions for underestimating the tax were properly imposed. The petitioner does not contend otherwise.

The decision of the Tax Court should be and is

AFFIRMED.

BROWN, Circuit Judge, Dissenting:

I do not understand how the entity concept, firmly and long since adopted by this Court,[12] can coexist with the hybrid contention that while the interest sold is an indivisible part of the whole entity, this does not include as a part of that entity that which, absent a sale of all, would have been taxable as ordinary income.

I recognize, of course, that courts continue to see a distinction but what they are in fact applying is but a sugar-coated version of the now-rejected aggregate theory that the microscope must be put on each and every asset, right or claim being effectually transferred in order to determine what would have been payable had the entire sale not been made.[13]

While I suppose we ought to know better than anyone else what we wrote and, more important, what we meant in *Le Sage v. Commissioner*, 5 Cir., 1949, 173 F. 2d 826, the system of written court opinions gives us no more right, no more prescience, than the most remote competent reader, Judge or lawyer. *Aetna Life Insurance Company v. Texas Gulf Sulphur Company*, 5 Cir., 1956, 235 F. 2d 791. As a cir-

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[12]See note 1. supra.

[13]Chopping up the "entity" cannot be justified on the basis that for the item to be a genuine capital asset subject to capital gains it must have been derived from partnership earnings on which the partners returned and paid an income tax. For example partnership *ABC* in the early part of the tax year earns $30,000 and invests it all immediately in a building. Partner *B* has fortuitous non-partnership deductions, etc. so no tax is due by him for that year. In the event of an outright sale of his partnership interest is his "portion" of the building ordinary income while the interests of partners *A* and *C* are capital assets, or vice versa?

cumstance which I regard of great significance the 8th Circuit has by express citation and reference[14] to our *Smith* and *Long* cases (note 1, supra) aligned us with the 6th, 7th and 8th Circuits in treating the sale as a capital gain. What the left hand in *Smith* and *Long* twice gave in March 1949, surely the right hand did not intend to take away ostensibly a month later in *Le Sage*.

But the Court does not finally put it on *Le Sage*. Nor would I. The transaction is a sale of an entire interest. It is the sale which is the decisive factor. What is sold is not merely the right to receive income theretofore earned and thereafter to be realized from past operations. It comprehends everything. The everything happens to include as an indivisible part what has been, or will shortly be, earned from prior operations. The sale of all is the thing. Devoted as we are to the proposition that the sauce is for goose or gander alike with a strict neutrality whether it helps or hinders government or taxpayer, *Weinert v. Commissioner*, 5 Cir., 1961, __F. 2d__ [No. 17992, August 31, 1961], this determines the tax consequence of that transaction. It is not determined by what might have been but never was. *General Gas Corporation v. Commissioner*, 5 Cir., 1961, __F. 2d__ [No. 18365, August 11, 1961].

I therefore

DISSENT.

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[14]See note 10, supra.

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Test: EDWARD W. WADSWORTH
Clerk, U. S. Court of Appeals, Fifth Circuit
By Gilbert J. Bonnecaze
Deputy
New Orleans, Louisiana
NOV 9 ...

JUDGMENT.

Extract from the Minutes of September 27, 1961

CHRIS J. SHERLOCK and LENORA SHERLOCK
(Lenora Chapman Sherlock, Executrix under the Last Will and Testament of Chris J. Sherlock, substituted as party petitioner in the place and stead of Chris J. Sherlock, deceased)

No. 18680 *versus*

COMMISSIONER OF INTERNAL REVENUE.

This cause came on to be heard on the Petition of Chris J. Sherlock and Lenora Sherlock (Lenora Chapman Sherlock, Executrix under the Last Will and Testament of Chris J. Sherlock, substituted as party petitioner in the place and stead of Chris J. Sherlock, deceased) for Review of a decision of the Tax Court of the United States, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered, adjudged and decreed by this Court that the decision of the Tax Court in this cause be, and the same is hereby, affirmed.

"Brown, Circuit Judge, dissenting"

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IN THE UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

No. 18680

CHRIS J. SHERLOCK and LENORA SHERLOCK (Lenora Chapman Sherlock, Executrix under the Last Will and Testament of Chris J. Sherlock, substituted as party petitioner in the place and stead of Chris J. Sherlock, *deceased*).

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

Petition for Review of Decision of The Tax Court of the United States (District of Alabama).

(October 30, 1961)

ON PETITION FOR REHEARING

Before RIVES, JONES and BROWN, Circuit Judges

PER CURIAM

IT IS ORDERED That the petition for rehearing in the above entitled and numbered cause be, and it is hereby DENIED.

Brown, C. J., Dissenting.

EXHIBIT "B"

SUPREME COURT, U.S.

Office-Supreme Court, U.S.
FILED
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No. 602

In the Supreme Court of the United States

OCTOBER TERM, 1961

LENORA SHERLOCK, INDIVIDUALLY AND AS EXECUTRIX OF THE ESTATE OF CHRIS J. SHERLOCK, DECEASED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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In the Supreme Court of the United States

OCTOBER TERM, 1961

No. 602

LENORA SHERLOCK, INDIVIDUALLY AND AS EXECUTRIX OF THE ESTATE OF CHRIS J. SHERLOCK, DECEASED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 21–32) is reported at 34 T.C. 522. The majority and dissenting opinions of the court of appeals (Pet. Ex. A, pp. 1–11) are reported at 294 F. 2d 863.

JURISDICTION

The judgment of the court of appeals was entered on September 27, 1961 (Pet. Ex. A, p. 12). Taxpayer's petition for rehearing was denied on October 30, 1961 (Pet. Ex. B). The petition for a writ of certiorari was filed on December 11, 1961. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the two courts below properly decided that, where taxpayer [1] had sold his interest in a partnership for a lump sum, the amount of taxpayer's share of the undistributed profits of the partnership, which profits had accrued prior to the effective date of the sale, was taxable to him as ordinary income.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations involved are set forth in the Appendix, *infra*.

STATEMENT

On June 1, 1951, taxpayer and two others organized a partnership which performed engineering and architectural services. The partnership agreement provided that the profits and losses should be borne equally, that any partner could withdraw from the firm upon prescribed notice, and that, in the event of such a withdrawal, the remaining partners would have an option to discontinue the business or to purchase the interest of the withdrawing partner. The partnership kept its books and records on the basis of a fiscal year ending April 30, and on the accrual method of accounting. (R. 23; Pet. Ex. A, p. 2.)

On February 26, 1954, taxpayer executed a bill of sale to his partners conveying to them his one-third interest in the partnership for $70,000 (R. 23–24;

[1] Lenora Sherlock is a party to this action as executrix and individually as a co-signer of a joint return. Consequently, as used in this brief, the term "taxpayer" refers to Chris J. Sherlock.

Pet. Ex. A, p. 2). The bill of sale stated (R. 24; Pet. Ex. A, pp. 2–3):

> 3. The books of the firm will be closed as of February 28, 1954, and seller withdraws as member of the firm and buyers will prepare, as soon as possible thereafter, returns of the income reflecting the profit and loss of the partnership for the period beginning June 1, 1953, and ending February 28, 1954. The profit between Chris J. Sherlock, Moreland Smith and Richard Adams; said returns shall be filed with the respective Governments and each of the parties will report their respective income from the partnership as shown by such returns. It is agreed that the profit and loss shown by such partnership to be the profit and loss of Sherlock has been received by him either through previous withdrawals or in the purchase price paid or to be paid by buyers.

Pursuant to provision 3 of the bill of sale, the partnership closed its books of account on February 28, 1954, and filed a return for the period May 1, 1953, to February 28, 1954. The return reported that the partnership income for the period was $249,827.38, that taxpayer's share of the income was $83,275.79, that the amount of his capital account in the partnership at the beginning of the period was a deficit balance of $9,641.59 (reflecting overdrafts), and that at the end of the period he had a credit balance of $49,303.80. (R. 24–25; Pet. Ex. A, p. 3.)

On the joint return filed by taxpayer and his wife for 1954, taxpayer reported the entire amount of the $70,000 paid to him for his partnership interest as a long-term capital gain computed with a zero basis,

but failed to report any amount of his distributive share of the partnership income for the period May 1, 1953, to February 28, 1954, as ordinary income. (R. 25; Pet. Ex. A, p. 3.) The Commissioner, in his notice of deficiency, determined that taxpayer should have included as ordinary income $83,275.78—his distributive share of the reported partnership profits for that period. The Commissioner also determined that the balance of taxpayer's capital account at the end of the period (*viz.*, $49,303.80) constituted taxpayer's basis in his partnership interest and should have been deducted from the $70,000 received by him for the sale of that interest, thereby reducing the amount of his reported capital gains (R. 14–17).

Subsequently, at the hearing, the parties stipulated that the correct amount of the partnership's income for the period May 1, 1953, to February 28, 1954, was $147,827.38; that taxpayer withdrew $14,233.95 during that period; and that his capital account at the beginning of the period had been overdrawn in the amount of $9,641.59 (R. 25–26; Pet. Ex A, pp. 3–4). Since the amount of taxpayer's deficiency had been computed on the basis of the income originally reported by the partnership, taxpayer's liability had to be recomputed (R. 27–28).

The Tax Court sustained the Commissioner's determination after making due allowance for the smaller partnership income stipulated by the parties (R. 21–32). Accordingly, the court included in taxpayer's ordinary gross income $49,275.79—the amount of taxpayer's distributive share of the partnership's profits

for the period in question, computed on the basis of the stipulated amount of partnership profit (R. 29). This resulted in a deficiency for the year 1954 of $19,372.54 (R. 33).[2] The court of appeals affirmed (Pet. Ex. A, p. 9).

ARGUMENT

The decisions of the two courts below are correct; there is no existing conflict; and the issue here involved is of no future importance. Further review is unwarranted.

1. The effective date of the termination of taxpayer's interest in the partnership was February 28, 1954. Taxpayer was therefore entitled to share in the partnership's profits until that date. (R. 24.) The parties stipulated that the ordinary income for the partnership for the fiscal year beginning May 1, 1953, and ending February 28, 1954,[3] was $147,827.38 (R. 34). Taxpayer was entitled to receive one-third of that amount—$49,275.79 (R. 23, 28).

Section 182 of the Internal Revenue Code of 1939, App., *infra*, provides that a partner must include in the computation of his gross income his distributive share of the ordinary net income of the

[2] The court also imposed penalties totalling $1,813.16 for the substantial underestimation of estimated tax and for failure to make timely payment of the amount of tax that was estimated. Taxpayer does not contest the imposition of those penalties in his petition.

[3] Because of taxpayer's retirement, the partnership filed a short-year return (R. 24–25). The income reflected accounts receivable entered on the partnership's books, which amounts had accrued to the partnership (which reported its income on the accrual basis) (R. 23).

partnership "whether or not distribution is made to him." See Treasury Regulations 118, Sec. 39.182–1, App., *infra*. Consequently, taxpayer was charged with his share of the partnership's profits up to the date of his withdrawal ($49,275.79), and he could not escape the tax liability that he had already incurred merely by selling his partnership interest. See Treasury Regulations 118, Sec. 39.113(a)(13)–2, App. *infra; Watson* v. *Commissioner*, 345 U.S. 544; *United States* v. *Snow*, 223 F. 2d 103 (C.A. 9th), certiorari denied, 350 U.S. 831; *Tunnell* v. *United States*, 259 F. 2d 916 (C.A. 3d); *Leff* v. *Commissioner*, 235 F. 2d 439 (C.A. 2d).

2. Contrary to taxpayer's contention (Pet. 4–5), there is no conflict among the courts of appeals on the question here involved. Taxpayer attempts to characterize the question as whether a lump sum payment received in consideration for the sale of a partnership interest must be treated as gain from the sale of a capital asset or whether such amounts of that sum which are attributable to the assignment of *future* income of the partnership may be treated as ordinary income. But that is not the issue in this case; the Commissioner has never disputed that the sale by taxpayer of his partnership interest (exclusive of his distributive share of the partnership income) was a sale of a capital asset (R. 30–31, 45–46). The Commissioner's contention, which was sustained by the courts below, is that the taxpayer's distributive share of the partnership income for the taxable period May 1, 1953, to February 28, 1954, was includible in his income for

that year under Section 182 of the 1939 Code, and the subsequent sale of his interest did not relieve him of that liability. See e.g., *United States* v. *Snow*, *supra*; *Watson* v. *Commissioner*, *supra*. Consequently, with the exception of *Meyer* v. *United States*, 213 F. 2d 278 (C.A. 7th), the cases cited by taxpayer (Pet. 4) are inapposite.[4] The *Meyer* case, in turn, is inconsistent with, and was therefore implicitly overruled by the more recent decision of the Seventh Circuit in *Hulbert* v. *Commissioner*, 227 F. 2d 399.[5]

3. In any event, the question here involved is of no continuing importance since it has been definitively re-

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[4] None of the other cases cited by taxpayer involved a situation where the income had been accrued by the partnership prior to the sale and was, therefore, distributable to the partner. For example, in *Swirin* v. *Commissioner*, 183 F. 2d 656 (C.A. 7th), certiorari denied, 340 U.S. 912, and *United States* v. *Donoho*, 275 F. 2d 489 (C.A. 8th), the partnerships reported on the cash basis. The contention of the government in those cases was that part of the selling price of the partnership interest represented an assignment of future income which was already earned.

Similarly in *Berry* v. *United States*, 267 F. 2d 298 (C.A. 6th), the partnership reported on the completed contract basis, and the sale was made before the contract was completed. Indeed, the court distinguished the *Snow*, *Leff* and *Tunnel* cases on that ground (267 F. 2d at 301).

United States v. *Shapiro*, 178 F. 2d 459 (C.A. 8th), involved the question whether the part of the selling price of a partnership interest which was attributable to the sale of noncapital assets should be treated as ordinary income. Although part of the selling price also reflected accumulated profits of the business, that amount was not involved in the litigation.

[5] See the dissenting opinion of Judge Lindley in *Hulbert* (227 F. 2d at 402) in which he states that the majority decision is irreconcilable with the *Meyer* case.

solved by Section 751 of the Internal Revenue Code of 1954, which provides that the amount of the selling price of a partnership interest that is attributable to either (1) unrealized receivables of the partnership or (2) inventory items which have appreciated substantially in value is treated as ordinary income. See also Section 1221(4) of the 1954 Code; H. Rep. No. 1337, 83d Cong., 2d Sess., pp. 65, 70–72 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4091, 4096–4099).

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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APPENDIX

Internal Revenue Code of 1939 (26 U.S.C. 1952 ed.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).

SEC. 183. COMPUTATION OF PARTNERSHIP INCOME.

(a) [as amended by Section 9(c)(1) of the Individual Income Tax Act of 1944, c. 210, 58 Stat. 231] *General Rule.*—The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual, except as provided in subsections (b), (c), and (d).

SEC. 187. PARTNERSHIP RETURNS.

Every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this chapter and such other information for the purpose of carrying out the provisions of this chapter as the Commissioner with the approval of the Secretary may by regulations prescribe, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each

individual. The return shall be sworn to by any one of the partners.

Treasury Regulations 118:

Sec. 39.113(a)(13)–2. *Readjustment of partnership interests.*—(a) When a partner retires from a partnership, or the partnership is dissolved, the partner realizes a gain or loss measured by the difference between the price received for his interest and the sum of the adjusted cost or other basis to him of his interest in the partnership plus the amount of his share in any undistributed partnership net income earned since he became a partner on which the income tax has been paid. * * *

* * * * *

Sec. 39.182–1. *Distributive shares of partners.*—(a) Each partner is required to include in his return for his taxable year within which or with which the taxable year of the partnership ends, whether or not distributed:

(1) As part of his gains and losses from sales or exchanges of capital assets held for not more than six months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for not more than six months.

(2) As part of his gains and losses from sales or exchanges of capital assets held for more than six months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for more than six months.

(3) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).

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